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EX PARTE

February 8, 1994

Mr. William F. Caton
Secretary
Federal Communications Commission
Room 222
1919 M Street NW
Washington, D.C. 20554

Re: RM No. 8388

Dear Mr. Caton:

Please place on the record of this proceeding the attached copy of From a Single Lane to the Superhighway: Rethinking Universal Service Policy for the 21st Century Consumer.

Sincerely,

Leonard S. Sawicki

Attachment

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MCI

From a Single Lane to the Superhighway:

Rethinking Universal Service Policy for the 21st Century Consumer

MCI

From a Single Lane to the Superhighway: *Rethinking Universal Service Policy for the 21st Century Consumer*

Sixty years ago, the Communications Act of 1934 established the basis for future US telecommunications policy. The Act's express purpose was "...to make available...to all people of the United States a rapid, efficient, nationwide and worldwide wire and radio communications service with adequate facilities at reasonable charges." Simply stated, Congress sought to ensure universal telephone availability regardless of economic or geographic factors. Thus, both city and country dweller would have easy and affordable access to local telephone service, a.k.a., "POTS" (Plain Old Telephone Service).

This policy, known as universal service, was achieved through a system of affordable rates for local service — "subsidized," in some cases, internally by the local exchange carrier (LEC) — by overcharging in other areas, like long distance and touch tone. As a result, some 94 percent of American households now enjoy the benefits of basic telephone service.

Though timeless, universal service — like those it serves — now stands at the crossroads of the information superhighway. While everyone agrees universal service should remain a vital component of future telecommunications policy, the combination of new technologies and a changing marketplace have rendered the current system obsolete. The emergence of new interactive multimedia services along with potential for competition in the local markets demands a new definition for universal service as well as a new funding mechanism.

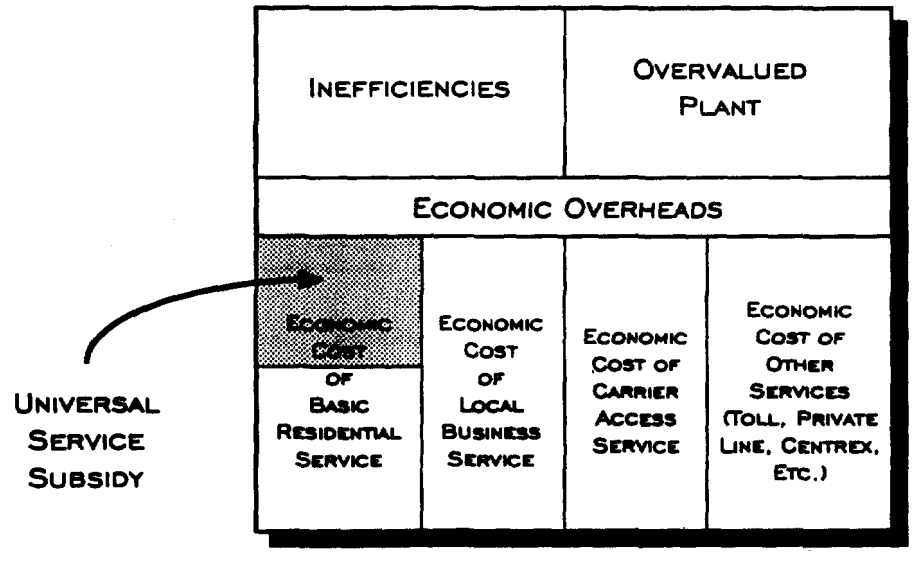
The Promise of Competition and Choice

Just as competition brought choice and lower prices to long distance customers over the past decade, the introduction of effective competition in the local market will deliver similar benefits to local telephone subscribers. Consequently, MCI, along with policy makers, regulators and consumer groups, believes that one of the goals for managing the transition to effective local competition is to construct a universal service policy that reflects the demands of today's consumers — choice, affordability and quality service.

De-linking LEC Revenue from Universal Service

The LECs claim that the universal service subsidy now flowing to residential local service is $20 billion and that universal service can only be maintained if that revenue stream remains intact. In reality, even a cursory examination of LEC profit levels in recent years — and their ability to generate enormous amounts of cash to invest in ventures domestically and abroad that have nothing to do with their local service responsibilities — would be enough to create strong suspicion that this subsidy requirement is vastly overstated. The above-cost pricing of certain local telephone services, among them the access charges paid by current long distance providers, would appear to far exceed what's truly needed to subsidize universal service.

This over-inflated number — a by-product of the LEC shell game of internal revenue shifting — really reflects the cost of their inefficient monopoly operations. By "de-linking" the notion of LEC revenue requirements from the funding of the universal service subsidy, public policy makers will ensure equal access to and fair distribution of the universal service subsidy.



The above chart shows the components of the LECs' overall revenue requirements. The cost components in the lower portion of the diagram — the economic cost of each of the LECs' services and the economic overheads of the firm as a whole — represent the costs which the LEC could recover from its rates if all of its services faced a competitive marketplace. Because the LECs currently operate as a monopoly, however, there are other costs — inefficient operations, overvalued plant, and excessive profits — which are included in the revenue requirement. Only the difference between the costs of basic local exchange service and the revenues generated by the service, the grey box labelled "Universal Service Subsidy," represents the true subsidy to basic local exchange service.

Today, by virtue of their internal subsidy, the individual LEC possesses a huge advantage over any potential competitor vying for the same customers. As long as this subsidy exists, the benefits that can be realized from effective competition will continue to elude local customers. Not surprisingly, those who have profited most from the universal service funding mechanism in the past — the local telephone monopolies — would like to see the system continue.

Indeed, the LECs have become accustomed to using the revenues they derive by substantially overcharging long distance carriers and consumers for local access to pad their profits and cover the losses of a myriad of unrelated new ventures. Future competition in the local market, they say, will stem the flow of that revenue which fuels the universal service subsidy, ultimately driving consumer prices up. Basic economic principles, however, dictate that fair competition will advance the cause of universal service by offering consumer choice, a well-known mechanism for ensuring low prices and high quality.

MCI and Universal Service

To reconcile the benefits of potential local competition and the information superhighway with the continuing national goal of universal service, MCI is proposing a new approach that promises to preserve and promote universal service into the next century. This two-tiered, consumer-oriented plan provides for both Basic and Advanced Universal Service, reflecting the rapid advance of information technology and how it is changing the ways in which Americans live and earn their living.

Basic Universal Service

Echoing the sixty-year-old call for affordable access to basic local service while, at the same time, reflecting the promise of a competitive local market, MCI's Basic Universal Service proposes access by residential customers to existing telephone network capabilities at affordable rates.

Six principles guide MCI's proposal for Basic Universal Service:

- *Defining the service*
- *Determining the amount of the required subsidy*
- *Generating funding in a "competitively neutral" way*
- *Distributing funding in a "provider neutral" way*
- *Regulating the transition to effective local competition*
- *Fulfilling carrier responsibility: consumer safety net*

Advanced Universal Service

In response to changing technologies, MCI's Advanced Universal Service fulfills the promise of the information superhighway by promoting digital connectivity and affordability for all consumers, and addressing concerns that we not be a nation divided into information "haves" and "have nots." At the same time, it will not saddle new financial burdens on consumers who do not need or want such services.

Four principles guide MCI's vision for Advanced Universal Service:

- *Encouraging private-sector development through tax credits*
- *Stimulating digital connectivity through cost-sharing of residential subscription*
- *Creating a separate funding base for benefitting industries (e.g., telco carriers, cable companies, CPE manufacturers, information service providers)*
- *Funding digital connection to libraries, schools and hospitals to the information superhighway through competitive bidding*

I. BASIC UNIVERSAL SERVICE

A. Defining the Service

Today's notion of universal service is not explicitly defined by either state or federal regulators, although it is generally described as access to the telephone network along with local usage. Furthermore, some features that most consumers consider "standard" still carry unjustified premium charges. For example, touch tone dialing, while less costly to provide than rotary-dial service, frequently carries an extra charge as it did when first introduced.

Not long ago, touch tone dialing was considered a novel departure from the once ubiquitous rotary telephone. Today, however, it is considered a standard feature by most consumers. In re-defining universal service for the future, public policy makers should seek to incorporate such "premium" services into a basic service package.

With this in mind, MCI believes that the definition of universal service ought to truly reflect what most consumers would expect and demand from their telephone. MCI's Basic Universal Service would provide residential local exchange service at rates no higher than the existing nationwide average of approximately $18 per month. Such "basic" services include:

- Access to the first point of switching (i.e., dial tone)
- Local usage
- Touch tone service
- 911 service
- White Pages listing
- Access to directory and operator assistance
- Single-party service

B. Determining the Amount of the Required Subsidy

To ensure basic universal service at an affordable rate within the parameters of a potentially competitive local exchange, the true amount of a universal service subsidy must be determined. Under the current system, internal subsidies — as well as lack of competition in the local market — have spawned inefficient operations, overvalued plant and excessive profits for local exchange providers. As a result, we can only estimate the true cost of basic local service; the amount of the subsidy which flows today has never been quantified. It is also not clear how much of the internal subsidy actually supports the goal of universal service and how much, in reality, supports the inefficiency of the local monopoly.

The specific subsidy for universal service cannot be known until the true cost of providing local service is identified. Under the MCI's proposal, the cost of performing specific network functions would be identified and quantified using an economic model that accounts for each function and recognizes the variables that affect cost, like population density. In fact, local phone companies already conduct similar cost analyses without undue hardship.

C. Generating Funding in a "Competitively Neutral" Way

MCI's proposed Basic Universal Service reflects Vice President Gore's stated belief that contribution to the universal service subsidy should be achieved on an "equitable and competitively neutral basis." Consistent with this belief, each carrier would contribute a percentage of its total telecommunications transmission and switching revenue, minus any payments to other carriers. The formula for the assessment would be based on the total amount of funding required for universal service divided by the total amount of revenue available for assessment. For example, if the LEC's average cost of providing basic local service is $25 per month and the average monthly charge is $18, a $7 per month subsidy would be required. For assessment purposes, the annual subsidy can be determined by multiplying this $7-per-month individual subsidy by the total number of ratepayers.

The first step in funding future universal service should be to identify those telecommunications providers who will contribute. Under MCI's Basic Universal Service proposal, they include:

- Current and future local exchange carriers
- Long distance carriers
- Competitive Access Providers
- Cellular telephone companies
- Pay phone providers

D. Distributing Funding in a "Provider Neutral" Way

Once the contributions to universal service are collected, the revenues would then be pooled and made available to permit reductions in local exchange service billing by ***any*** carrier. It is essential that a single, independent third-party oversees and administers the funding pool to ensure competitive neutrality. Under Basic Universal Service, a "Universal Service Association" would be created to replace today's antiquated system where the local telephone monopolies themselves are in charge of collecting, distributing and enjoying the subsidies.

Once effective competition in the local market is achieved, current monopoly providers will have to share subsidy benefits with new competitors. As a result, local customers, for the first time, will have the right to "spend" their universal service benefit with the local service provider of their choice. To ensure that the benefit follows the customer, MCI's Basic Universal Service proposes the use of "virtual vouchers" to apply toward their selection of telephone services. If such a system were already in place today, local customers — not the LEC — would be able to determine the type of service and specific provider to receive their universal service subsidy. For example, if a LEC says its real cost of providing local service is $25 per month and its subsidy is $7, the difference — $18 — is billed to the customer. But, if a more efficient competitor enters the market and is able to provide the same service for $20 per month with the same subsidy of $7, the customer ultimately would pay a bill of only $13.

Despite the current difficulty in determining the true cost of local service, the LECs claim they charge above their costs for local service in larger towns and cities so that they can offer rates below costs in less populated rural areas. Such inconsistency favors more lucrative urban markets in the eyes of competitive carriers, and when they rationally act upon those economic incentives, the monopoly providers immediately cry "creamskimming."

However, the mechanism described above for distributing the universal service subsidy assures an even-handed approach, providing benefits commensurate with the cost of service in each area. As a result, carriers could reflect the true cost of service in their rates and competitors would have an incentive to expand into those previously underserved areas.

E. Regulating the Transition to Effective Local Competition

If the long distance market is any measure, it will take a number of years before the local exchange achieves true and viable competition. As a result, policy makers must continue regulatory oversight of existing LECs for a number of reasons:

- To prevent LECs from leveraging market power to increase rates for non-competitive local service and other essential access services;
- To maintain non-discriminatory access for competitive service providers;
- To assure smooth transition to a new universal service subsidy mechanism.

F. Fulfilling Carrier Responsibility: Consumer Safety Net

If only one carrier is willing to serve a particular exchange, that carrier has the obligation to serve all customers within that exchange. If the subsidy is properly set for that location, there is no undue burden in serving all customers there. However, despite the incentives for all carriers to serve all markets, MCI's proposal recognizes the possibility where an existing provider may be unwilling to meet this responsibility even with the subsidy normally provided under the Basic Universal Service plan. In such an instance, the Basic Universal Service plan would include an auction feature, whereby, carriers would "bid" the level of per-line subsidy at which they are willing to serve the entire customer base within the local exchange. The carrier that requires the smallest subsidy would become the new local service provider, presumably prepared to provide service to all and still make a profit. This procedure provides a "fail safe" system to protect all consumers regardless of income and/or geographic location.

II. ADVANCED UNIVERSAL SERVICE

MCI's Basic Universal Service proposal seeks to reconcile current policy with the development of competition in the local exchange. MCI's vision for Advanced Universal Service, however, goes beyond that to address the economic issues related to the emerging technologies comprising the information superhighway.

A. Private-sector Development

Many of the nation's policy makers believe that the private sector, not the government, should be the engine that drives future technological development. MCI fully agrees. Contributing to this view is the anticipated price tag associated with technological development and delivery — to residential customers — of the information superhighway. For example, most agree the cost of replacing the existing telecommunications infrastructure by deploying fiber optic technology would vastly outweigh the benefits. It would be imprudent to impose a large subsidy burden to ensure widespread delivery of such services in the immediate future which would increase rates for all customers — whether they want or need digital services — and thus depress demand for existing services.

Moreover, it is not yet clear which technology will best suit customer needs, nor whether demand will be sufficient to defray the cost of some technologies. Therefore, the general goal of Advanced Universal Service will be to stimulate — rather than lead — the demand for new and emerging multimedia services. Experience with other recent technological developments, such as the VCR and cable television, illustrates the role of consumer demand in driving the market. Too much is at stake to adopt an "if we build it, they will come" approach to delivering technology of yet undetermined value to the average consumer. Rather than trying to dictate demand, Advanced Universal Service would supplement already proven services and technologies, allowing consumers to chart the course of the information superhighway.

According to Bellcore, more than two-thirds of the access lines of the largest LECs are scheduled to be ISDN-equipped (Integrated Services Digital Network) by 1994. To ensure that trend continues as well as expands into rural and other underserved areas, MCI's Advanced Universal Service would propose investment tax credits for LECs and other providers in the business of deploying digital end-to-end capabilities.

B. Stimulating Digital Connectivity through Cost-sharing of Residential Subscription

One of the concerns that has often been voiced by consumers and public policy makers alike is that lower-income households — in both rural and urban areas — will miss out on the benefits of interactive multimedia services due to their high costs. In light of this potential inequity and to the extent that general consumer demand may fall somewhat short of what's needed to encourage companies to provide such services, policy makers may need to play a role in stimulating consumer demand. To avoid the creation of a large subsidy burden, MCI proposes the creation of a separate virtual voucher system — not unlike Basic Universal Service — to provide the government with a mechanism for encouraging consumer demand.

C. Creating a Separate Funding Base for Benefitting Industries

Once consumer demand for digital services is evident — thanks to the incentives described above and the development of local competition — further stimulation of that natural demand may be considered. Depending on how much stimulation is required, Advanced Universal Service would provide funding through a broad-based subsidy pool involving all industries that stand to benefit.

For example, if, as many public opinion surveys predict, movies on demand will top the list of what consumers demand from the information superhighway, then the entertainment industry would represent a natural contributor to a separate funding pool. Similarly, information service providers, computer hardware and software vendors and other companies that benefit from the acceleration in demand for the information highways should contribute to this funding pool. Like Basic Universal Service, the actual subsidy benefit would be redirected toward the ***consumer*** via the "virtual voucher." But, Advanced Universal Service will protect the "basic service" consumer from subsidizing high-tech services and benefits for those "digital" consumers more likely to use and afford them.

D. Funding Digital Connection to Libraries, Schools and Hospitals to the Information Superhighway through Competitive Bidding

To the extent that the government is seeking to achieve its public policy goals of providing digital connectivity with schools, libraries and hospitals to the information superhighway, it should refrain from making deals with monopolists for these services. Rather, a system should be instituted whereby all providers offer competitive bids to earn such business. Such a competitive bidding process would give beneficiaries — schools, hospital and libraries — the ability to choose from the best technology available and avoid the pitfalls of the current approach. Otherwise, some monopolies, in exchange for their "largesse," might look to the government for permission to overcharge captive ratepayers or engage in predatory tactics to extend their monopoly control into adjacent service areas.

Conclusion

Like their counterparts sixty years ago, today's policy makers shoulder the responsibility of crafting a regulatory policy that ensures universal availability to telephone service. Unlike their counterparts, however, today's policy makers inherited a system which prevents competition, stifles consumer choice and pads the profits of monopolists. In light of such inefficiency and inequity, there is no question that a re-definition of universal service must capitalize on the enormous potential of new and emerging technologies while, at the same time, be compatible with the development of competition in the local exchange.

By defining a basic service package for all customers, widening the flow of the current universal service subsidy to include additional local service providers and establishing an independent third-party to oversee and administer that subsidy, MCI's Basic Universal Service will ensure a fairer system that promotes choice, affordability and high-quality service for all consumers. Likewise, MCI's Advanced Universal Service — by stimulating digital connectivity, encouraging private-sector development through tax incentives and spreading the costs of new technologies — will allow consumer demand and free market forces to determine the construction and direction of the information superhighway.